EROS International Media Ltd (NSE Code: EROSMEDIA) – Alpha/Alpha + stock recommendation for Jan'13

Content Index

Dear Members,

The Indian media and entertainment (M&E) industry is one of the fastest growing industries in the country. Its various segments – films, television, animation, print and Out-of-home advertising (OOH) among others have witnessed remarkable growth in the past few years.

The M&E industry is witnessing a healthy growth thanks to cable digitization, wireless broadband penetration, increasing direct-to-home (DTH) penetration, digitization of film distribution and growing internet usage. The growth trajectory is backed by strong consumption in Tier II and III cities, continued growth of regional media, and fast increasing new media business. Overall, the industry is expected to register a CAGR of 15% to touch Rs 145,700 crores by 2016.

Within M&E, Indian movie industry has been witnessing sweeping changes with increased corporatization, digitization of film distribution, value added services like movie on demand, cable and satellite licensing deals and increasing penetration of multiplexes in tier I, II and III cities and we believe **EROS** is best positioned to capitalize on the above opportunities in the film entertainment and television industry in India.

EROS International Media Ltd (NSE Code – EROSMEDIA) – EROS is one of the leading Producers/Distributors in the Indian film industry and has been one of the pioneers in taking Indian films to the global audiences by leveraging its well-established global distribution network.

It exploits its content globally, through its offices in India, Nepal and Bhutan and parent company's offices in UK, USA, UAE, Singapore, Australia, the Isle of Man and Fiji. Presently, the company has an extensive and impressive library of 1,100 plus Hindi, Tamil and regional language films which it licenses to Indian broadcasters. The company has had deals with all top four Hindi GEC broadcasters viz. Star Network, Sony, Zee and Colors. Its distribution formats includes theatres, home entertainment, television and digital new media.

Investment Snapshot (As on 20th Jan'13)

Recommendation – Buy

Portfolio Allocation Strategy –

1. Start with ~3-4% portfolio allocation in the range of 200-210.
2. We may consider increasing allocation in case of a correction to around 160-175.

Profit Booking – Refer Alpha/Alpha + weekly

Current Market Price – Rs 207.20

BSE Code – 533261; **NSE Code** – EROSMEDIA

Bloomberg Code – EROS: IN

Market capitalization – Rs 1,900 cr.

Total Equity shares – 9.18 cr.

Face Value – Rs 10.00

52 Weeks High/Low – Rs 235.05/ Rs 153.05

Promoter's holding – 74.59%

EROS International Media Ltd – An Introduction

Eros International Media Limited (EIML) is part of the Eros group, which has been in the Indian media and entertainment sector for close to three decades. Eros plc, the holding company of the Eros Group, is the promoter of EIML and is listed on the Alternative Investment Market of the London Stock Exchange.

EIML is the leading producer/distributor in India with the largest library comprising of more than 1100 Hindi, Tamil and other regional language movies. The company sources content primarily through acquisitions from third parties and through co-productions and, occasionally, through own productions and then distributes the content in multiple formats.

EIML acquires films from third party producers at various stages of a film's production for an agreed contractual value, and also co-produce films from inception with certain producers for a pre-agreed fixed budget. The company has had long industry associations, a consistent track record of releasing three to four movies of the top 10 movies in the box office and a wide distribution network. Eros has been able to develop strong relationships with key figures in the Indian film industry, which helps it secure key films and build a strong portfolio of movies.

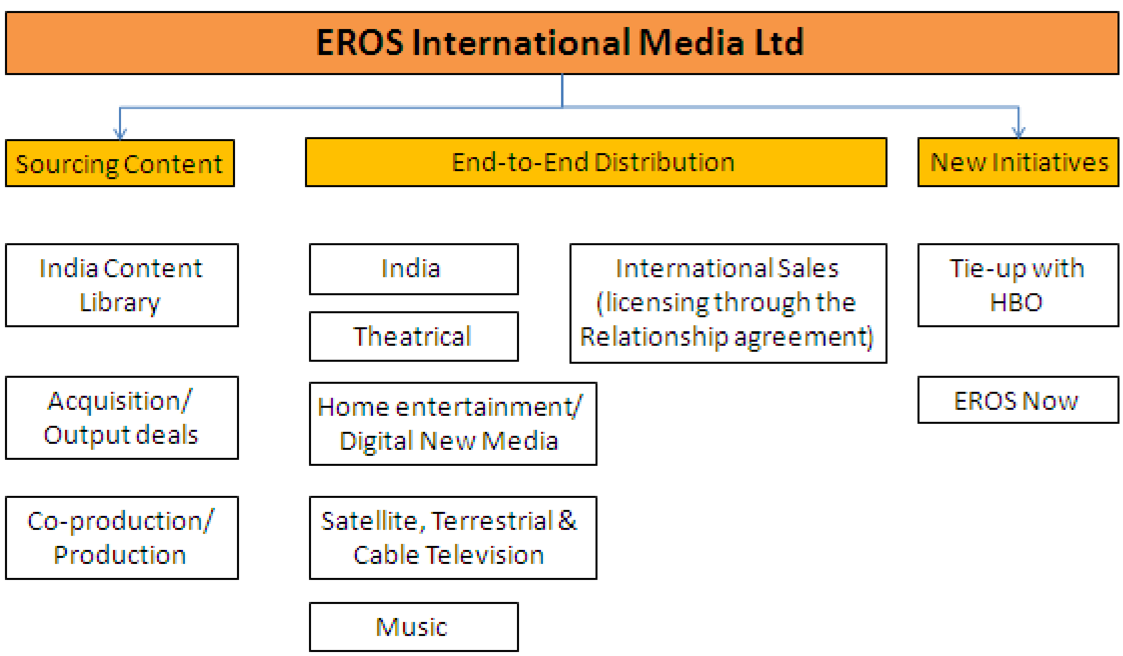
The company distributes end-to-end Indian film content within India, Nepal and Bhutan through multiple formats such as multiplexes and single screen theaters, home entertainment in the form of DVDs, VCDs and audio CDs, and television syndication which primarily involves licensing the broadcasting rights to major Hindi (Star, Zee, Sony, Colors, etc) and regional entertainment channels. It also distributes content via digital new media such as mobile ring tones, wallpapers, internet protocol television (**IPTV**), direct-to-home (**DTH**) and other internet channels and also licenses films to airlines for in-flight viewing.

The company distributes movies to Indian multiplexes and single screens through its internal distribution offices in Mumbai, Delhi, Punjab, Chennai and Mysore and also through sub-distributors.

Outside India, Nepal and Bhutan the company leverages on its parent's (Eros International Plc and Eros Worldwide) presence and licenses the international rights to the Eros International Group in accordance with the terms of the **Relationship Agreement** between EIML and its Promoters, Eros Worldwide and Eros plc. The parent companies have offices in Dubai, Singapore, the US, the UK, Australia and Fiji.

EROS – Business Model

Over the years Eros has de-risked its business model to a large extent wherein the dependence on theatrical revenue for big budget films is far lesser than that of other distribution firms. It has achieved the same through relationship agreement with its parents, Eros International Plc taking care of its overseas distribution, increasing TV syndication charges, a strong portfolio of movies from yesteryears that can be bundled with new releases to get a higher price, a co-production model and other newer streams of monetizing the content.



Sourcing Content

EROS Library – EROS boasts of a strong movie library of 1100 plus movies of yesteryears. Along with that, the company keeps adding 70-80 movies annually. The strong movie library helps Eros monetize the rights of its new movies better. It is important to note here that Eros has the highest number of movies in its catalogue and leads the second highest in the industry by far.

The extent and nature of the Eros India Library allows the company to follow a distribution strategy of combining its new releases with films from existing catalogue. For example, its television syndication strategy is driven by licensing new film releases and Eros India Library films to television channels as a bundle. Furthermore, the revenues generated from the exploitation of films from its library have high margins because a substantial proportion of the cost of films in the Eros India Library is written down within the first few years following their theatrical release.

The company recently signed a deal with Colors channel in India worth Rs 95 crores wherein some of the company's new and existing movies would be shown exclusively on Colors channel. Other major deals include exclusive license of 35 previously released films to Sahara One and 16 other films to Sony, Colors and 9X where telecasts were shared between the three channels in a particular order for a limited period of time.

Content sourcing, acquisition and co-production – The Company generally co-produces 60% of its movie slate. Apart from co-producing, the company also acquires movies from third party and also produces a few movies on its own.

	Execution Role	Creative Council	Cost	Scalability
Acquisition	Low	Low	Market Value	High
Co-production	Moderate	Moderate	Cost plus arrangement	Moderate-High
Production	High	High	At cost	Low

Production – EROS does not undertake more than one or two own production films in a given year as this is a time-consuming process which is difficult to control and to build scale.

Co-production – Co-production is the most widely followed model by the company for acquiring content followed by acquisition from third-party producers. The key difference between a co-produced film and a produced film is that the production line responsibility lies with the co-producer the company works with. Typically, once the star cast, budget and expected cash outflow is decided, the co-producer takes the lead in production and execution. The company does all the financing required for making the movie and also pays a production fees to the co-producer for his services.

In return, Eros gets to keep worldwide distribution rights for a certain period (20 year exclusive rights + perpetual copyrights). Also, the company only shares the revenue with the co-producer after they have recovered the entire cost of the movie including the distribution and marketing cost along with an additional commission for their investment.

As per the management, EROS typically gets a first position recoupment of 20% on all gross revenues, followed by the recovery of print and advertising (P&A) costs along with the entire investment on the movie. The remaining profit, if any, is shared with the co-producer in a pre-agreed ratio. The management has indicated that the pre-agreed ratio normally tends to be 50:50, 60:40 or 70:30 with Eros getting the higher share.

Co-production model allows the company to develop multiple big budget projects simultaneously with different talent thereby allowing them to build scale.

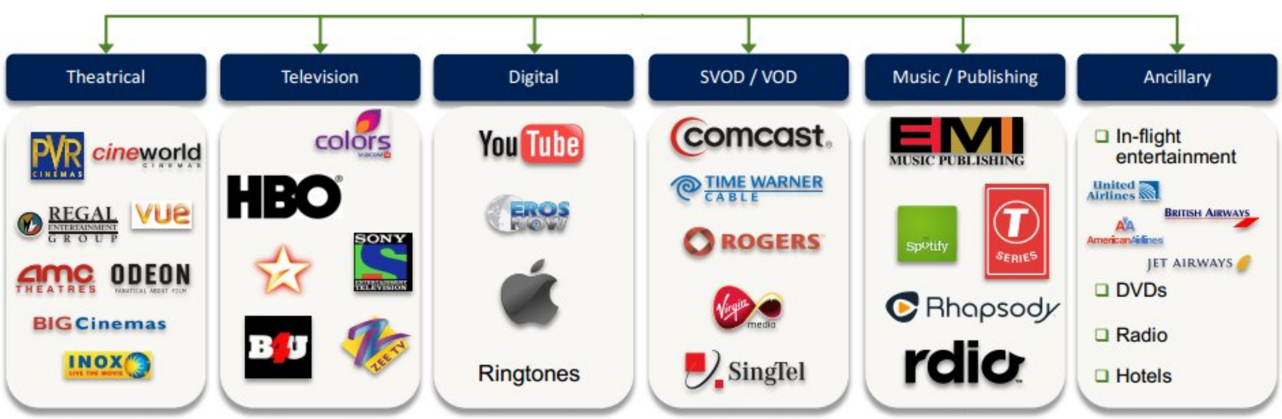
Acquisition from third-party producers – The Company also acquires movies from third-party producers wherein the film is evaluated at a very early stage when the concept and budget becomes available or during the course of its production at a negotiated price.

In an acquisition model, generally 35-50% of the total acquisition cost is payable when the film is delivered by the producer to the company near its release date. According to the management, Eros gets a first position recoupment of 20% of gross revenues, followed by all P&A costs and the entire minimum guarantee price (in a minimum guarantee plus royalty model). The remaining profit is shared with the producer in a pre-agreed ratio.

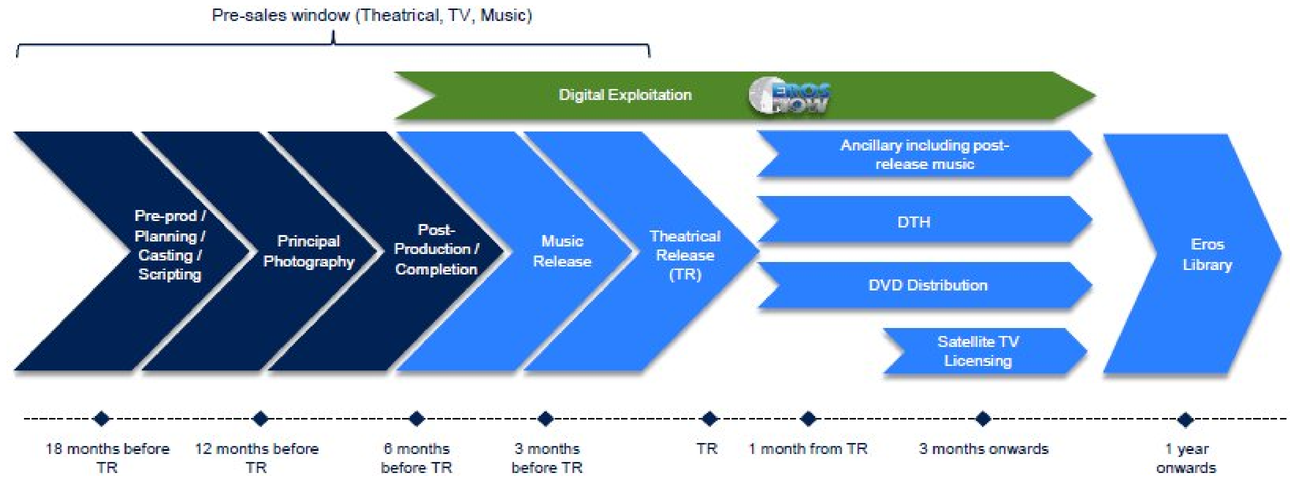
End-to-End Distribution

One of the key strengths and competitive advantage of EROS is its extensive distribution network which enhances its ability to monetize its content without solely relying on sub-licensing to third parties.

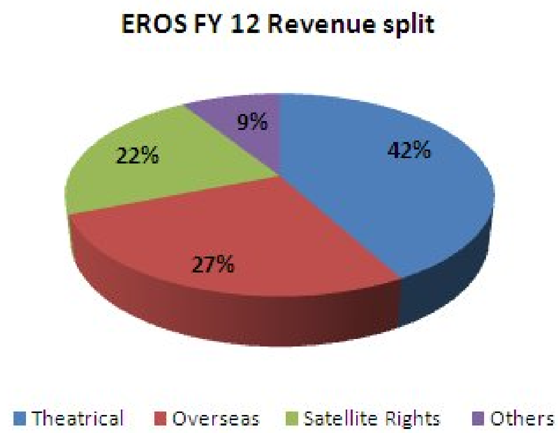
EROS is one of the few companies within the Indian media and entertainment sector to have an end-to-end (all format) distribution capability through a national and overseas (through relationship agreement with its parent company) theatrical distribution network, in-house music distribution capability with its own music record label Eros Music, an in-house television syndication team, and home entertainment distribution division.



Various distribution platforms



Film monetization timeline



As a distributor, Eros has access to different streams to monetize its content at different points of time with respect to its release date. The non-theatrical streams have been gaining significance recently owing to increasing internet users in India, digitization of the cable & satellite industry and increasing competition among Hindi GEC (General entertainment channels such as Zee, Sony, Star, Colors, etc) broadcasters.

In FY12, theatrical revenue contributed 42% of the overall revenue pie of EROS. The overseas distribution revenue by virtue of its relationship agreement with its parent and sale of TV rights contributed 27% and 22% of the total revenue, respectively, while other revenue including music, home entertainment and new media chipped in at 9% of total revenue.

Theatrical

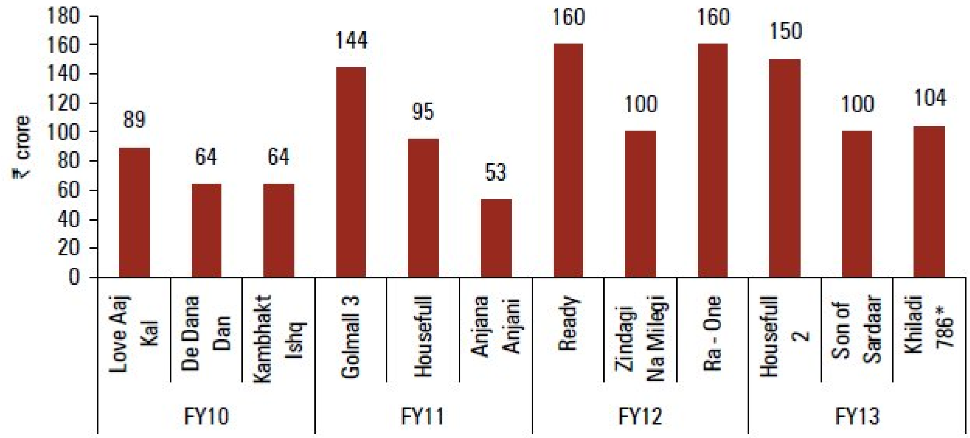
EROS distributes Indian film content to both multiplexes and single screen theatres throughout India, including digital screen theatres.

For theatrical distribution within India they have established their own distribution offices in some of the key markets in India, namely in Mumbai, which also services the rest of Maharashtra, Goa and Gujarat, in Delhi, which also services Uttar Pradesh, and in Punjab. They distribute in West Bengal through an exclusive distribution agent and in Tamil Nadu through either the distribution office of Ayngaran or through sub-distributors.

The advantage of having its own well established distribution network is that it allows them greater control, transparency and flexibility over the distribution process as well as higher revenue margins as a result of direct exploitation instead of using sub-distributors, which requires the payment of additional commission.

EROS follows a strategy of releasing its movie across large number of screens and since the proportion of digital screens has improved significantly, the print cost hasn't gone up much. The advantage with wide distribution strategy is that EROS receives a larger percentage of the theatrical revenues from a film in the first week of its release and the same mitigates the adverse effect on revenue where a film fails to gain popularity or critical acclaim in the longer term.

As per the various reports, Eros has consistently been able to deliver three to four movies annually in the top 10 Hindi movies at the box office and Eros currently commands ~40% share of the box office collections.



*- latest

Source: Company, ICICI

Eros – Top 3 Hindi Movies

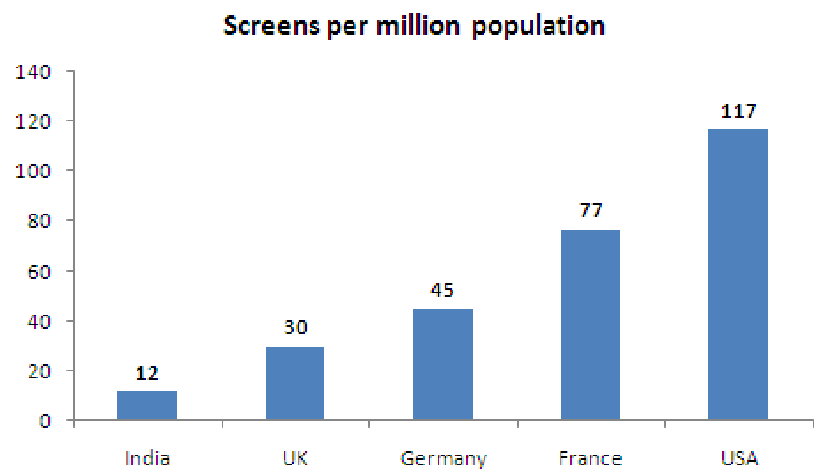
Revenue sharing with the Exhibitors (Multiplex and Single screen theaters) – The box office collections received from exhibitors is shared in different ways with distributors. Multiplexes share 50% of net box office collections with the distributor in the first week, 42.5% in the second, 37.5% in the third and 30% from the fourth week onwards. However, the single screen theatres, due to a lower bargaining power, end up sharing ~60% of the net collections with the distributor.

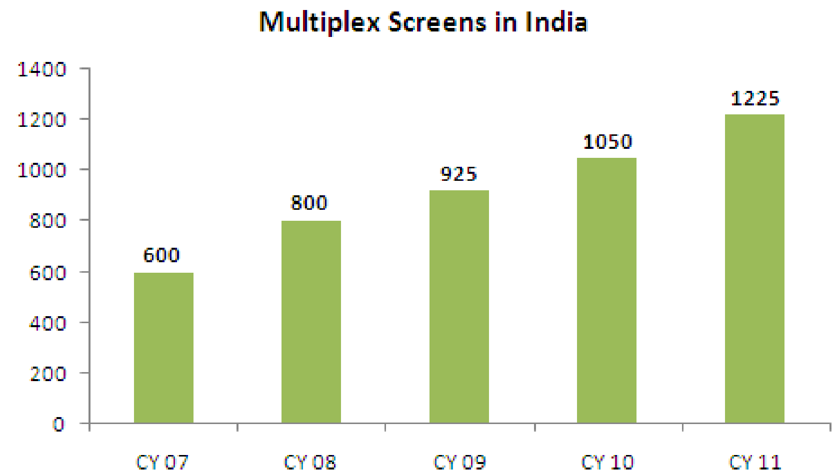
Growth in theatrical revenue – Though unpredictable and highly volatile, the growth in theatrical revenue is likely to be driven by the combination of following factors:

1. Increase in volume of movies with co-production and acquisition from various third party producers.
2. Growth in multiplexes which still account for 15% of the total screens in India.
3. Higher average ticket prices as the ticket prices in multiplexes are much higher than those in single screen theaters.
4. Wider release: As per the management, *Om Shanti Om*, a blockbuster of EROS released in ~1000 screens in 2008 while some of the big budget movies of 2012 released across 3,500 screens. Digitization of screens has played a crucial role as it has made possible wider release at substantially lower distribution cost.

Growth in Multiplexes in India – It's been only a few years since the introduction of concept of Multiplexes in India; however it has brought in a major transformation in the movie viewing experience for the consumers.

Multiplexes provide better ambience than a single screen theatre and also a choice to consumers with four to six screens in one location. Hence, multiplexes command a premium on ticket prices over the single screen cinemas even at higher occupancy levels. Higher occupancy at higher average ticket prices is well represented by the fact that in spite of total multiplex screens being ~15% of the total number of screens in India, in CY11, multiplexes accounted for more than 50% of theatrical revenues.





Though in the last 4-5 years the number of multiplex screens has more than doubled, they still account for only 15% of the total number of screens in India and since India is still highly under-penetrated in comparison to the developed countries in terms of the number of movie screens per million population, there's huge potential for growth of multiplex screens over the next many years.

Multiplexes have a strong presence in urban areas and therefore multiplex operators are currently looking at expansion in Tier II/ Tier III towns and the southern regions, which are currently dominated by single screens. As per the estimates released by CRISIL, the number of multiplex screens is expected to double to ~2200 screens by the end of 2016.

Movies with more than 100 crore box office collection				
2008	2009	2010	2011	2012
Ghajini	Three Idiots	Dabangg	Ready	Agneepath
		Golmall3	Singham	Housefull 2
			Boduguard	Rowdy Rathore
			Ra One	Bol Bachchan
			Don 2	Ek Tha Tiger
				Barfi
				Jab Tak Hai Jaan
				Talaash
				Dabangg 2
				Khiladi 786
				Son of Sardar

The growing influence of multiplexes with their higher average ticket prices can be estimated from the fact that just one movie crossed Rs 100 crore box office collection in 2008 and 2009, 2 movies in 2010, 5 movies in 2011 and 11 movies breached the mark in 2012.

Overseas distribution: Relationship agreement with parent

EROS has entered into a relationship agreement with Eros plc and Eros Worldwide, dated December 16, 2009, effective from October 1, 2009.

Eros Worldwide has agreed to acquire, absolutely and unconditionally, exclusive distribution rights for Indian films (meaning films produced, co-produced or acquired within the territory of India, Nepal and Bhutan, excluding Tamil language films) for which Eros India holds distribution rights outside the territory of India, Nepal and Bhutan, for exploitation outside the said territory.

EROS Worldwide would bear 30% of the entire production cost of such a film with an additional mark-up of 30% thereon payable to EROS India. This translates into 39% guaranteed recovery of costs for EROS India.

Further, gross proceeds received by the Eros International Group for exploitation of such rights outside the specified territory shall be shared between the Eros International Group and the Eros India Group in a 70:30 ratio, subject to the Eros International Group being entitled to retain its minimum guarantee fee, a commission of 20% of the gross proceeds and any distribution expenses incurred by it.

Satellite, Terrestrial & Cable Television rights

Satellite television broadcasting rights licensing involves licensing Indian film content (usually a combination of new releases and films in the Eros India Library) for a number of years pursuant to agreements that generally allow a certain number of telecasts of a film over a stated period of time in exchange for a specified license fee.

There are several models for satellite television syndication. In the **"syndication model"**, a group of channels share the broadcast of a specified set of films between them in a certain order and pay EROS separate license fees. In the **"Alternative licensing model"**, EROS creates a straightforward exclusive license in favor of one particular channel for broadcast on its channels for a specified period of time.

As mentioned above, EROS boasts of a strong movie library of 1100 plus movies of yesteryears and keeps adding 70-80 movies annually. Eros has the highest number of movies in its catalogue and leads the second highest in the industry by far. The strong movie library helps Eros to monetize the rights of its new movies better.

For instance, EROS recently signed a deal with Colors channel in India worth Rs 95 crore wherein some of the company's new and existing movies would be shown exclusively on Colors channel. Similarly, in 2008 they exclusively licensed 35 previously released films to Sahara One for a period of 5 years and 16 other films to Sony, Colors and 9X where telecasts were shared between the three channels in a particular order for a limited period of time.

We believe the competition among GEC broadcasters (Colors, Zee, Sony, Star, etc) bodes well for Eros as it implies rising sales from TV rights for the company. **Consider this:** As per FICCI KPMG report 2012, increasing competition among broadcasters led to 30-35% annualized increase in movie acquisition cost by the broadcasters over the last three years.

Satellite rights cost paid by broadcasters							
2009		2010		2011		2012	
Movie	Cost	Movie	Cost	Movie	Cost	Movie	Cost
Ghajini	20-25	3 Idiots	30-35	Ra One	35-40	Ek Tha Tiger	65
Singh is King	15-20	Housefull	15-20	Bodyguard	25-30	Don 2	35-40
Welcome	10-15	Dabang	10-15	Rajneeti	20-25	Agneepath	35-40

Also, with digitization, the revenue leakage due to under reporting in the analog cable system would be plugged and broadcasters are expected to witness a 3-4x jump in their subscription revenue. All Hindi GECs are expected to improve their quality of offerings to garner a higher share of the subscription pie. With cricket and movies being the most popular among the India viewers, movie rights are further expected to be in demand and EROS with its strong library is well positioned to capitalize on the opportunity.

Music rights

Besides an important source of revenue, music is used as a major tool to promote the release of a film by releasing the music album 6-8 weeks prior to the film's release.

EROS has developed its own music label, Eros Music, to exploit music rights by publishing and distributing Indian film soundtracks and songs.

Music rights are mainly monetized in three different ways: digital rights, physical rights and ancillary rights.

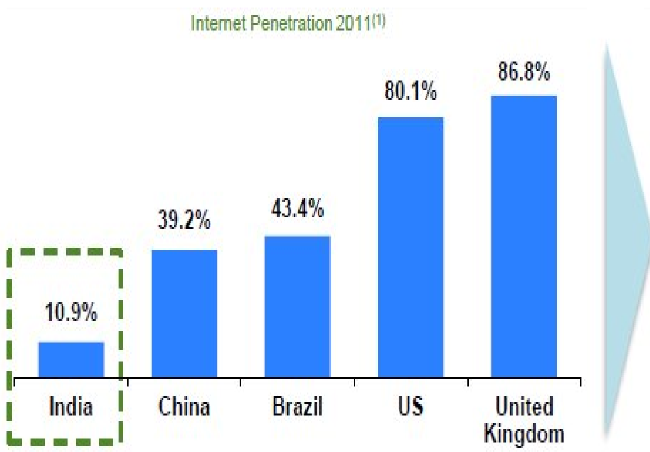
Digital rights include mobile ringtones, paid downloads and wallpapers monetized mainly through telecommunication platforms. Digital rights segment provides huge potential for growth in the light of increasing internet penetration.

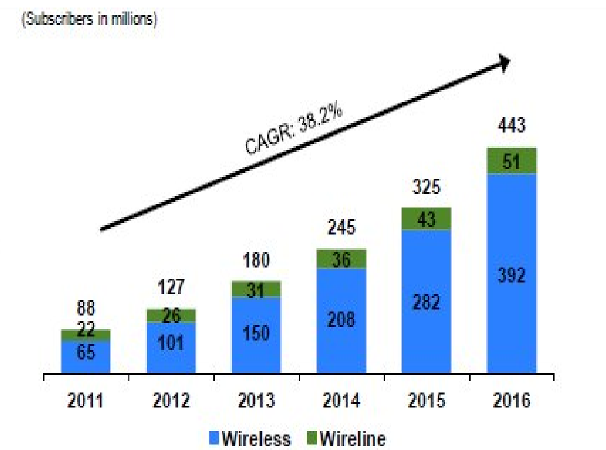
Physical rights such as audio cassettes, CDs, etc. are losing their market share at a great pace due to unchecked piracy, while ancillary rights involve revenues from licensing songs to radio and television channels to play on their networks, as well as royalties from public performance of these songs when they are played in public places and at events.

Ancillary revenue streams

In FY 12, music, home entertainment and new media chipped in at 9% of total revenue of EROS.

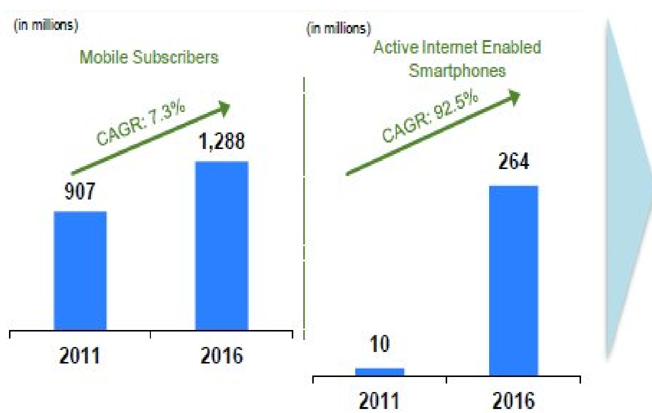
While home video (DVD distribution) segment has lost its appeal to a distributor due to unchecked piracy, ancillary revenue streams including pay per view (PPV) on the DTH platform and potentially on digital cable are growing much faster. Similarly digital music in the form of ring back tones, paid downloads and other new media revenue streams such as airborne rights, IPTV services are also growing rapidly.





Internet penetration in India in 2011

Expected growth in Internet Connections



As per the FICCI KPMG – 2012 report, India currently has a very low smart phone penetration and low data usage as compared to some of the developed or developing countries. However, it has a significant potential to grow owing to various initiatives by operators, handset OEMs and VAS providers such as decreasing device prices, availability of affordable data plans and development of mobile internet ecosystem around consumers in India.

We believe, over the next few years growing internet penetration and higher data usage per subscriber would be a major growth driver for ancillary revenue streams of any distributor.

New platforms for distribution

Strategic collaboration – HBO & EROS

Eros has formed a strategic tie-up with HBO to launch two ad-free premium television channels in India: HBO Defined and HBO Hits.

The main features of the two channels will be as below:

- Advertising free premium channels with a subscription based model
- First television window after theatrical and DVD release
- The channels shall include 30% Hindi and other Indian language films, while balance 70% will be English movies.
- Besides EROS, content will be provided by 2 other studios – Paramount and Warner Brothers
- Channels shall be offered in both Standard and High Definition

The main features of the collaboration are as follows:

- Eros has no equity investment in the tie-up. The only contractual obligation that Eros would have in the deal is to provide 10-12 premiers a year for a first window post theatrical release along with ~100 library titles every year
- The movies delivered by Eros could be in Hindi as well as regional languages
- Eros is free to license those films to other broadcasters after a one month exclusive window on the premium channels
- All three studios – EROS, Paramount and Warner Brothers will have an equal share of the agreed revenue received from MSO/DTH before the operational and overhead costs of the channel

- All costs including technical and marketing costs would be borne by HBO.
- The profits after deducting the marketing and overhead costs would be shared equally between HBO and Eros
- EROS and HBO will have a Joint steering board to devise strategies and marketing plans and programming initiatives as well as negotiate carriage deals jointly

As Eros does not have any equity investment in the tie-up and since it won't have to incur any operating expenses, we believe the deal with HBO provides a good opportunity to the company depending on the number of subscribers subscribing to the two channels.

The downside of the above deal is that EROS can sell satellite rights of the movies premiered on the two HBO channels to other channels only after one month exclusive telecast on HBO. Since broadcasters get the highest viewership in the first telecast of a movie and since they won't get the first telecast right for some of the movies of Eros, they may bargain with Eros for a lower price.

The loss of TV syndication revenue would be minimal when the subscriber base of the HBO channels is small as broadcasters only tend to lose a small part of their viewership. However, as the subscriber base of HBO Hits and HBO Defined grows, broadcasters would negotiate strongly for the pricing of satellite rights, which at that time would be more than compensated by the profit that Eros receives from HBO.

Moreover, depending on the demand and the price offered for a particular film, Eros can sell the satellite rights of a movie to a broadcaster directly, without giving it to HBO, as its contractual obligation is only to supply 10-12 new movies a year.

Movie slate for FY 13 and FY 14

Since Eros is primarily in the business of movie production and distribution, it's extremely important for the company to plan 12-24 months in advance for any financial year and sign movie co-production and acquisition deals with various production houses.

For the same, the company has a separate Green light board, which consists of Eros executives that run the business in India and abroad. The board executes a thorough review of the film projects based on creative as well as financial criteria.

In the past, the performance of the Green light board has been good with Eros consistently delivering 3-4 films in the top 10 movies at the box office every year since CY09 and even now the company has a strong visibility of its movie slate for the next 24 months with the movie releases planned as below:

Movie slate – Selective list of forthcoming releases in FY 13 and FY 14

Film Name	Star Cast/(Director)	Scheduled Release (Fiscal Year)
Attacks of 26/11	(Ram Gopal Verma)	FY 13
3G	Neil Nitin Mukesh, Sonal Chauhan	FY 13
Warning (3D)	Santosh Barmola (Anubhav Sinha)	FY 13
Go Goa Gone	Saif Ali Khan, Kunal Khemu	FY 13
Dekh Tamasha Dekh	Satish Kaushik (Feroz Khan)	FY 14
Rangeeley (Punjabi)	Jimmi Shergill	FY 14
Kochadaiyaan (Tamil, Hindi, Telugu)	Rajnikanth, Deepika Padukone	FY 14
Ye Jawani Hai Deewani	Ranbir Kapoor, Deepika Padukone	FY 14
Peddlers	Selected for Cannes, 2012	FY 14
Dishkiyaaoon	Sanjay Dutt, Harman Baweja	FY 14
Ranjha	Dhanush, Sonam Kapoor	FY 14
Bajate Raho	Tushar Kapoor, Vir Das	FY 14
Ram Leela	Ranvir Singh, Deepika Padukone	FY 14
Tanu Weds Manu – 2	R. Madhavan, Kangana Ranaut	FY 14
Rambo Rajkumar	Shahid Kapoor, Sonakshi Sinha	FY 14
Singh Saab The Great	Sunny Deol	FY 14
Krrish 3	Hritik Roshan, Priyanka Chopra	FY 14
Illuminati Films (Untitled)	Saif Ali Khan	FY 14
Sarkar – 3	Amitabh and Abhishek Bachchan	FY 14
Rana (Tamil, Hindi, Telugu)	Rajnikanth	FY 14
Boney Kapoor (Untitled)	Arjun Kapoor (Okkadu remake)	FY 14
Bajirao Mastani	(Sanjay Leela Bhansali)	FY 15
Tamil Untitled	Rajnikanth	FY 15

3 Films with Endemol India	Various	FY 15

Source: Company

Performance Snapshot

Particulars (in cr.)	Mar'12	Mar'11	Mar'10	Mar'09	Mar'08	Mar'07	Mar'06	Mar'05
Revenue from Operations	943.88	706.97	640.88	626.52	474.71	217.94	102.09	110.6
Operating profit	212.39	156.14	113.03	113.68	55.11	16.23	7.14	2.94
Operating profit margin (%)	22.50%	22.09%	17.64%	18.14%	11.61%	7.45%	6.99%	2.66%
Other Income	19.3	8.95	12.62	1.26	15.47	6.83	1.46	0.25
Finance cost (net)	13.44	9.39	9.02	6.1	2.81	5.21	4.46	2.87
Depreciation	6.00	3.82	4.39	4.97	1.79	0.94	0.97	1.43
Profit Before Tax	212.25	151.88	112.24	103.87	65.98	16.91	3.17	-1.11
Tax	63.14	33.67	29.62	29.15	23.26	3.41	1.25	0.71
Profit After Tax	149.11	118.21	82.62	74.72	42.72	13.50	1.92	-1.82
Share of Minority interest in Profit/(Loss)	1.27	0.98	0.5	1.42	1.59	0.27	-0.02	0.02
Net Profit/(loss) after Minority interest	147.84	117.23	82.12	73.30	41.12	13.23	1.94	-1.84
PAT Margin (%)	15.80%	16.72%	12.89%	11.93%	9.00%	6.19%	1.88%	-1.65%
Cash flow from operations	40.12	173.81	126.7	-88.52	104.96	104.52	-30.44	4.41
Return on Average Equity	19.65%	25.82%	41.51%	61.19%	66.89%	37.92%	7.09%	

ROE and growth – As can be observed from the above illustration, the company's performance has been very good over the years and consistently delivered return on equity in excess of 20% without employing excessive leverage (net debt equity ratio of 0.12 at the end of FY 12).

Further, ignoring the small base of FY 05-07, the company has consistently been recording ~20% growth in sales turnover and much higher growth in profits on account of expansion in operating and net profit margins.

Operating margins – Regarding margins, there's been a gradual expansion in operating profit margins of the company from ~18% to around 22% in the last 4-5 years. As per the management, it has largely been on account of economies of scale and continuous expansion and monetization of films library through bundle deals with satellite channels. The revenues generated from the exploitation of films from its library have high margins because a substantial proportion of the cost of films in the Eros India Library is written down within the first few years following their theatrical release.

Cash Flows – As can be observed above, EROS has consistently been generating positive cash flows from operations and to a large extent in line with reported profits. The same has enabled the company increase the number of co-productions/acquisitions in a year while maintaining a very low debt equity ratio of less than 0.15.

Very high promoter holding

	Dec'12	Sep'12	Jun'12	Mar'12	Dec'11
Promoter and Promoter Group	**74.95%**	**77.80%**	**77.80%**	**77.84%**	**77.98%**
India	23.64%	23.65%	23.65%	23.66%	23.71%
Foreign	51.31%	54.15%	54.15%	54.18%	54.27%
Public	**25.05%**	**22.20%**	**22.20%**	**22.16%**	**22.02%**
Institutions	10.04%	8.55%	9.40%	10.31%	11.52%
FII	7.33%	6.30%	7.03%	7.89%	8.52%
DII	2.71%	2.25%	2.37%	2.42%	3.00%
Non-Institutions	15.01%	13.65%	12.80%	11.85%	10.50%
Bodies Corporate	7.42%	5.04%	4.43%	3.46%	3.27%
Custodians					
Total	**9,18,33,668**	**9,17,77,720**	**9,17,77,720**	**9,17,36,857**	**9,15,66,186**

The Promoters of the company – Eros Worldwide, Eros Digital and Lulla family jointly hold ~75% stake in the company and therefore their interest in the company is well aligned with the interest of minority shareholders.

Earlier, they had 78% equity in the company; however in Dec'12 they had to dilute their stake through an 'Offer for Sale' in order to meet the minimum public shareholding requirement of 25%. The Company had fixed Rs 200/- as the floor price for the 'Offer for Sale' of 25.7 lakh shares and the same got oversubscribed 4.4 times.

Dividend Policy

Despite the fact that company has consistently been reporting good set of numbers, EROS has not declared any dividend.

We believe it's one of the major negatives about the company and holds us from suggesting very high portfolio allocation. We hope that management formulates a dividend distribution policy in the near future and starts distributing 10-20% of net profit in the form of dividends.

Valuations

As has been observed in the previous few sections, EROS has brought in sweeping transformations and corporatization in the Indian film and entertainment industry and has minimized the risk of capital loss to a large extent by adopting the following three approaches:

1. Portfolio approach to film slate by budget, genre and language (Hindi and regional language movies)
2. Pre and post-sales (with respect to theatrical release) of movie rights (music, satellite licensing) covering 35%-67% of film production cost
3. Bundling of content (new releases and movies from its vast library) for licensing to cable networks and broadcasters

Furthermore, EROS has been very efficient with capital allocation, consistently delivered high return on shareholder's funds and has developed certain strengths/capabilities (longstanding relationship with talent, largest multi-platform distribution network in India and overseas) which should help the company extend advantage over its peers and grow at a much higher pace in comparison to the industry.

Also, structural changes in the theatrical business (increasing penetration of multiplexes and higher average ticket prices), better monetization of content through premium TV, pay per view and satellite rights on the back of imminent digitization will continue to fuel the earnings growth of the company.

As far as valuations are concerned, EROS is currently available at a market cap of Rs 1,900 and holds around 100 crore debt in the balance sheet. For FY 13, we expect the company to record Operating profit (EBITDA) of ~225 crores.

Considering the operating performance of the company, efficient capital allocation and overall growth prospects we believe the valuations are reasonable and significantly lower (in comparison to other media companies) with market capitalization at ~12.5 times FY 13 (E) net profit.

This is not to say that the stock cannot witness any short term corrections, however 10-15% correction to ~Rs 160-175 will make the stock even more attractive for long term investment.

In view of the same, we would suggest an initial portfolio allocation of 3% with further increase in allocation to 5% in case of a correction to Rs 160-175.

Risks & Concerns

Theatrical revenues tend to be very volatile and unpredictable. If in a year company is unable to deliver 3-4 top grossing movies, the profitability of the company can nose-dive.

The company has agreements with multiplex chains and single screens in place for distribution of movies. In future, if negotiations on revenue share fail (as was the case from Mar'09-Jun'09), especially with large multiplexes, the revenues of the company may get affected or the release of a movie can be delayed.

The relationship agreement between the company and its parent, which assures 39% cost recovery of movies with international rights, is set to expire in October 2014. Though we expect the agreement to be renewed, the terms of the agreement change may not be as favorable as the current one for the Eros India group.

Katalyst Wealth – Alpha/Alpha + Portfolio

Katalyst Wealth **Alpha/Alpha + Portfolio** service is focused on helping individual investors/institutions beat market returns by a wide margin without taking large risks through in-depth research, analysis and follow up on the stocks.

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